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Some Recurring *Shari'ah* Violations in Islamic Investment Agreements Used by International Banking Institutions

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ABSTRACT

Most recurring violations in Islamic investment agreements international banking institutions use occur in conditions attached to contracts, which are subject to four important *Shari'ah* provisions. Although indemnity clauses are in most international trade and commercial agreements and do not usually mention interest, the wording of most of them actually runs afoul of the *Shari'ah*. Most of the misconception arises from confusion between indemnities and guarantees: the guarantor provides a guarantee against something, while an indemnity is a form of insurance against outside variables. In its worst form, indemnity makes one party liable for things neither under its influence or control nor related to the transaction itself. Although such conditions clearly violate the *Shari'ah*, not every indemnity clause is forbidden (*daman al-derak*, for instance, is permissible). Indexation of lease payments to the LIBOR and inclusion of a "hell or high water" clause, both common in conventional lease contracts, violate the *Shari'ah*.

I. INTRODUCTION

The volume of Islamic finance carried out by conventional banks is growing every day. Unfortunately, *Shari'ah* supervision on the Islamic banking practice of these banks is inadequate because *Shari'ah* experts who are well versed in English and equally knowledgeable in banking and law are quite rare. When a violation occurs in a transaction and passes unnoticed by the *Shari'ah* supervisory board, it keeps recurring. Many banks just copy the format of agreements used by others, assuming that the previous user has adequately attended to the *Shari'ah* aspects. Many Western law offices try to fill this *Shari'ah* expertise gap. However, few lawyers are able to actually appreciate the intricate differences beyond the general principles between the *Shari'ah* and the Western legal system.

The area where most recurring violations occur in Islamic investment agreements used by international banking institutions is that of conditions in contracts. The subject of conditions in exchange contracts is a profound area of Islamic jurisprudence. Conditions in contracts, though left to the mutual agreement and consent of the parties, are nevertheless subject to the provisions of the *Shari'ah*, which has its own rules and requirements in such conditions.

First, no condition is allowed if it causes the contract to change in nature. In such cases the parties must follow the rules and requirements of the de facto contract, not the declared one. For example, if it is a condition in a *mudaraba* contract that the *mudarib* guarantees capital to the *rab-al-mal*, then the de facto contract is a loan rather than a *mudaraba*. Hence, the parties must follow the *Shari'ah* rules for lending; namely that no benefit should accrue to the provider of capital.

Second, the *Shari'ah* is keen on maintaining just exchange. Therefore, contracts must not be used to permit one party to take advantage of another. Hence *Shari'ah*-acceptable contracts are not manipulative. It is not permitted to include in a contract conditions that are not germane to the transaction involved.

Third, exchange contracts should always be separated. Merging two contracts may void both. Therefore, one has to be careful of conditions that may in effect create a contract within a contract. For example, if one sells an item to another with a condition that the buyer lends him money, then both contracts are void, though if separated, both are valid and permissible.

Fourth, conditions that, although part of the contract, are uncertain or ambiguous are not be permitted. For example, the price in an exchange contract should be specified and known to both parties at the time of contract. If this is not satisfied the contract might be void.

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II. THE INDEMNITY CLAUSE

Indemnity is a standard clause that appears in most trade and commercial agreements, particularly ones done internationally. Since an indemnity clause will usually not mention interest, it is assumed (or so it appears) that including such a clause in an Islamic banking agreement is permissible. However, the wording of most indemnity clauses the writer sees actually renders these agreements void from a *Shari'ah* point of view. Most of the misconception emanates from confusion between indemnities and guarantees. This part will define the indemnity clause and the difference between an indemnity and a guarantee. Examples of the indemnity clause will be presented, and finally the *Shari'ah* aspects will be discussed.

A. Meaning of Indemnity

An indemnity is different from a guarantee because the obligation of the guarantor in a contract of guarantee is the same as that of the principal debtor. In an indemnity, such undertaking is independent, in its content and enforceability, from the terms and volatility of that given by the debtor. For example if A says to B, "Supply goods to C. If he does not pay you, I will." This would be a contract of guarantee. But if A says to B, "Supply goods to C, and I will see to it that you receive the price," this is an indemnity.

In an indemnity contract, one party might indemnify the second respecting the second party's liability to the first. It could also involve an insurance, such as arrangement, where one party is indemnifying a second party to a contract in respect of the second party's liability to a third party arising from that contract.

Both indemnity and guarantee are a form of security. The reason for both is to give the other party protection against certain perils and liabilities. Nevertheless, an indemnity is different from a guarantee. A guarantee is provided by a party (the guarantor) against something. Because the ownership of the other party (the beneficiary) is already established by the contract, it becomes a defined obligation on the other party. For example, A sells his car to B on deferred payment. The price becomes an obligation against which B will provide a guarantee from a third party or collateral of some sort. However, an indemnity is a form of insurance, the purpose of which is to make sure that a certain position is protected from the effect of outside variables that might affect on the final outcome. In the previous example, if B protected A against the fall in the purchasing power of the sale price, this then is a form of indemnity.

B. Examples of Indemnity Clauses Found in Some Islamic Banking Agreements

The first example is from a *murabaha* agreement in which a bank is selling equipment on a deferred payment basis to a foreign client. The bank (i.e. the creditor) wants the client (i.e. the debtor) not only to guarantee prompt payment of the amount due, but also to indemnify against several possible obligations that may fall on the bank. The agreement reads:

> If, by reason of (i) any change after the date hereof in any law or in its interpretation or administration and/or (ii) compliance with any request from or requirement of any central bank or other fiscal, monetary, or other authority made after the date hereof (including, without limitation, a request or requirement which affects the manner in which the seller allocates capital resources to its obligations hereunder):
>
> the seller incurs a cost as a result of its having entered into and/or performing its obligations under this agreement, any purchase agreement or any supply contract and/or assuming or maintaining a commitment under this agreement;
>
> the seller is unable to obtain the rate of return on its overall capital which it would have been able to obtain but for its having entered into and/or performing its obligations and/or assuming or maintaining a commitment under this agreement, any purchase agreement, or any supply contract;
>
> the seller becomes liable to make any payment on account of tax or otherwise (not being a tax imposed on its overall net income) on or calculated by reference to the amount of its commitment or payments under this Agreement, any purchase agreement, or any supply contract and/or by reference to any sum received or receivable by it hereunder or thereunder,
>
> then the purchaser shall, from time to time and no later then twenty-one (21) days following demand therefore by the seller, pay to the seller amounts sufficient to indemnify the seller against

> (1) such cost, (2) such reduction in such rate of return (or such proportion of such reduction as is, in the opinion of the seller, attributable to its obligations hereunder), or (3) such liability."

The second example is also from a *murabaha* agreement. It reads:

> "The purchaser shall indemnify and hold [the Bank], the Collection Agent, their directors, officers, employees, and agents harmless on an after tax basis from and against all expenses, claims, actions, liabilities, costs, and proceedings which [the Bank], the Collection Agent or their directors, officers, employees, or agents may incur, or which may arise, directly or indirectly, out of or in connection with this agreement, each Contract of Purchase, holding or disposing of any Supplies, or otherwise howsoever in connection with this Agreement."

It is apparent that the bank, in these two agreements, not only desires to assure the full payment of the amount due by the buyer of this equipment, but also wants to make sure that recouping its investment and seuring its return is assured regardless of what happens.

C. Indemnity from a *Shari'ah* Perspective

Indemnity, in its worst case, boils down to making one party liable for things that are neither under his influence or control nor are related to the transaction itself. Such conditions are in clear violation of *Shari'ah* rules and they render the contract, void from a *Shari'ah* point of view. However, the *Shari'ah* does not forbid every indemnity clause. In fact, it allows certain indemnities: in classical *Shari'ah* books one finds what is called *daman al-derak*.

D. Why the indemnity clause?

From the standpoint of the law, the parties involved in a contract do not only create rights and obligations through the contractual relationship. They also allocate between themselves the risk of possible contingencies. They agree beforehand to allocate all or some of the loss. It is apparent that such allocation can only be done within a legal framework that allows the assignment of risk for monetary compensation. Within a legal system that allows such transfer, an indemnity clause of this nature creates no problem because the parties could have formed a separate contract designed solely for the transfer of risk for a price. However, such a contractual relationship is dubious from a *Shari'ah* point of view. The condition is not any more permissible if it is stated in a *murabaha* contract rather than in an autonomous contract.

III. FLOATING RATE LEASES

In conventional leases, rental rates may be fixed, but they can also be variable by way of indexing the rental payments. In this case, lease rates will be adjusted as an independent variable changes.

In most cases, these payments are related to the LIBOR (London Interbank Offered Rate) or a similar variable. This becomes especially necessary in contracts that are 5 years or longer, as the need of matching assets and liabilities for the lessor becomes a critical one. Indexing rental rates to the LIBOR is quite prevalent, even in agreements that are called Islamic.

Two examples from actual "Islamic" lease agreements reads as follows:

> "Profit: Three (3) months US$LIBOR for the relevant lease period plus a margin of 5% per annum."

> "Monthly rental payments will be made on an annual adjustable basis through the life of the lease payment [and] will be calculated according to floating LIBOR + 3%."

A lease from a *Shari'ah* point of view is a sale contract. The sold object is the usufruct of the leased assets, the price is the periodical payment. Like any other exchange contract within the *Shari'ah*, the price must be known at the time of contracting without any uncertainty or vagueness. If this requirement is not satisfied, the contract is null and void. Indexing the lease contract to the LIBOR means that rental rates can only be known in the future, as the future value of the LIBOR itself is unknown. The *Shari'ah* forbids this.

A. "Hell or High Water" Clause

Conventional lease contracts often include what a "hell or high water" clause. Under such a clause, the lessee is obliged to pay the full rental payments regardless of any event affecting the leased equipment. This provision assures the lessor that the lease payments will be made unconditionally.

An example from an actual "Islamic" lease agreement is:

> "This lease agreement will provide for a 'net' lease whereby all risks and costs of ownership, maintenance, insurance, repair, and operation will be borne by the lessee."

As mentioned earlier, a lease under the *Shari'ah* is a sale contract. The sold items are the usufructs of an asset that will survive the term of the contract. The lessor deserves his compensation, (i.e. the rent) only if such usufructs can be extracted in the same level contemplated in the contract. Hence, if the leased equipment is damaged to the degree that such usufructs are no longer generated, the lessor is not entitled to rents. Clearly, the lessee is liable for damages caused by his own negligence or misuse.

Furthermore, lease contracts are based on trust. The lessee is entrusted with the leased assets that remain in his custody. Hence, the lessee can not be held liable except when it is proven that he failed to live up to expectations of honesty or that he breached the trust.

Therefore, the *Shari'ah* does not permit a hell or high water clause. The problem becomes particularly acute in the case of a full-payment lease contract, in which the entire relationship ceases to be lessor-lessee and becomes